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Backgrounder

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Time to Settle the Tax Issue for the Resources Industry

Jack M. Mintz

With renewed interest on the part of investors in developing energy resources, it is important for the federal and provincial governments to settle corporate tax issues for the resources industry. A unique opportunity now exists not only to provide a more stable tax environment for the industry but also to improve the tax system as a whole, with internationally competitive tax rates and greater neutrality among sectors. The aim should be to reduce the federal corporate income tax rate on resources profits from 28 percent to 21 percent, as provided for other sectors, and to replace the resource allowance with deductibility for resource royalties as payment for the cost of using provincially owned resources. Other changes could also contribute to a better tax system, removing the most important economic distortions while enhancing the competitiveness of the resources sector. These measures would result in a single corporate income tax rate on all industrial activities at the federal level and in several provinces by 2005.

In the February 28, 2000, budget and October 2000 mini-budget, the federal government proposed to reduce the general corporate income tax rate from 28 percent to 21 percent for all sectors except resources.[1] Instead, Ottawa invited the resources industry to discuss a new tax regime for business taxation. With the development of a continental energy policy and the need to look for new supplies of resources, it is important to conclude these discussions and move ahead with a stable, more competitive tax environment for the sector. This *Backgrounder* suggests a way to improve the tax structure for the resources industry and for the economy as a whole.

A More Competitive Corporate Tax System for All Industries

The federal government's rationale for not reducing tax rates for the resources sector was that the sector already enjoys significant benefits from tax writeoffs, which yield

1 The proposal would eliminate the manufacturing and processing deduction, leaving a single federal tax rate of 21 percent for all sectors except resources. The resources sector includes oil and gas and mining industries.

lower effective corporate income tax rates on capital than other industries enjoy. From this perspective, cutting the rate without any changes to the tax base would not improve the neutrality of the corporate income tax system.

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Many resources industry representatives argue that the 2000 federal budget changes were unfair. They have a point. Nonmanufacturing industries that benefitted from a rate reduction did not experience a scaling back of tax writeoffs, such as the research and development tax credit, that benefit them. If the corporate tax system is to become internationally competitive with low rates and more neutral treatment of investment, all Canadian industries should be included in any reform.

What would a corporate tax system look like if the resources sector were treated the same as other industries? Two provisions in particular would result in much greater neutrality and substantially reduce distortions in the tax system.

First and foremost, Ottawa should include the resources sector in its proposed lowering of the federal corporate income tax rate on profits from 28 percent to 21 percent. Different tax rates on profits in different industries make little sense; rather, they result in unequal treatment of industrial investments and substantially complicate the tax system. In a world in which businesses engage in many types of activities — production, distribution, manufacturing — at the same time, it is simply impossible to allocate revenues and costs in a simple way across different activities to determine the amount of profit that should be subject to income tax.

Second, nonrenewable resource companies should be able to deduct royalty payments for the benefits of using resources derived from Crown lands, just as the forest industry can deduct stumpage fees and other businesses can deduct freehold royalties and patent costs. The federal government should, therefore, replace the resource allowance, which is now 25 percent of nonrenewable resource profits (profits gross of interest and exploration and development expenses), with a deduction for nonrenewable resource royalties. The original intention of the resource allowance was to prevent increases in provincial royalties from eroding the federal corporate tax base — and in some cases, the tax bases of other provinces. This argument is now outdated. Provincial concerns over competitiveness and job creation are sufficient to keep royalty rates down, for fear of losing production to other countries. Further, replacing the resource allowance with resource royalty deductibility would eliminate the need to define resource profits, a task that is just as difficult as trying to tax profits at different rates depending on the type of activity.[2]

These two changes to the corporate tax system would go a long way toward making the tax system more efficient, simpler, and fairer. Tax all industrial profits at the same rate regardless of the type of business activity. Let companies deduct the royalty payments as a benefit of using technologies or resources, no matter their form. This would result in a much more neutral corporate tax system and in internationally competitive tax rates.

Other adjustments could ensure that all industries are treated similarly. For example, capital cost allowances for all industries should reflect their true economic costs, which would mean that businesses could face increases or reductions in

2 A move to royalty deductibility would, however, have distributional impacts on firms. Although many companies would benefit from the replacement of the resource allowance with royalty deductibility, others would not since their royalty payments are less than the resource allowance. But coupled with the corporate tax rate reduction, most would see their taxes fall.

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depreciation costs allowed for tax purposes. For the resources sector, this could mean some scaling back of incentives such as accelerated depreciation.[3] One could also consider providing support for exploration on a basis similar to that used in the case of research and development. A tax credit for investments in exploration would be far better than the current highly inefficient provision of tax benefits to owners of qualifying new share issues; such benefits are eroded by transaction costs and, in some cases, provide targeted support for projects that are otherwise unable to obtain funding. If some of these considerations were to obstruct the timely implementation of lower rates and a redefined base, they might be deferred to a later date. On the whole, however, the case for including them in a comprehensive tax reform is strong.

Reform Is Needed Now

What is the stumbling block to the introduction of a sensible tax reform package? Depending on the package of changes, taxes paid by the resources industry could be reduced. Given the current high level of profits in the resources sector and the fiscal needs of governments, there may be some reluctance to reduce industry taxes further. But resources prices are highly volatile. If the industry is to remain competitive beyond the current boom, Ottawa should provide a more stable tax environment for investments in the longer run. This can be achieved with lower corporate income tax rates and a less distortionary tax treatment of costs.

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To accommodate revenue concerns and limit initial revenue losses, Ottawa could phase in the deductibility of resource revenues and any other provisions as it reduces corporate income tax rates.

In summary, the federal government would be wise to extend to the resources industry the same tax changes that it has proposed for other industries. Cutting rates and reforming the tax base to put the resources sector on a more competitive footing makes economic and tax policy sense.

3 For a review of tax provisions that especially affect the resources sector, see the report of the Technical Committee on Business Taxation (Ottawa: Department of Finance, 1998).

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Jack M. Mintz, the author of this *Backgrounder*, is President and Chief Executive Officer, C.D. Howe Institute, and Arthur Andersen Professor of Taxation, Joseph L. Rotman School of Management, University of Toronto.

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